

DRY FORK COAL COMPANY

IBLA 97-575

Decided March 27, 2001

Appeal from a decision of the Acting Associate Director for Policy and Management Improvement, Minerals Management Service, denying an appeal from a Valuation and Standards Division, Royalty Management Program, Minerals Management Service, decision requiring inclusion of a management fee, paid to affiliate as part of gross proceeds, for royalty valuation purposes, and payment of additional royalty. MMS-95-0245-MIN.

MMS decision reversed, VSD decision vacated.

1. Coal Leases and Permits: Royalties—Mineral Leasing Act: Royalties

A management fee paid by buyers to their agent for coal procurement need not be included as part of "gross proceeds accruing to the lessee," for royalty valuation purposes, pursuant to 30 C.F.R. § 206.257(c) (1995). Such a fee may be excluded from gross proceeds when the lessee demonstrates, by a preponderance of the evidence, that the management fee is not part of the total consideration paid for the coal, in accordance with 30 C.F.R. § 206.257(b)(5) (1995).

APPEARANCES: Brian E. McGee, Esq., Denver, Colorado, for appellant; Howard W. Chalker, Esq., and Geoffrey Heath, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE TERRY

The Dry Fork Coal Company (Dry Fork) has appealed from a decision of the Acting Associate Director for Policy and Management Improvement, Minerals Management Service (MMS), dated July 1, 1997, denying an appeal from a March 14, 1995, decision of the Valuation and Standards Division (VSD), Royalty Management Program, MMS, directing it to include a \$0.125 per ton "management fee," paid by the Basin Electric Power Cooperative (Basin Electric) to the Western Fuels Association, Inc. (WFA), as a part of the gross proceeds accruing to Dry Fork, for royalty valuation purposes, and the payment of additional royalty owing thereon.

The facts of this case are, for the most part, not disputed. WFA is a

nonprofit, member-owned corporation organized [in 1974 by Basin Electric and the Tri-State Generation and Transmission Association, Inc. (Tri-State)] for the purpose of obtaining a reliable, low-cost fuel supply to be used in the generation of electric energy by its members, and arranging for the delivery of such fuels to the members' point of use, such fuel to be obtained either (a) by purchase from others, or (b) by the operation of mines or extraction from other sources of fuels which it may acquire or lease[.] [Emphasis added.]

(Ex. 2 attached to MMS Answer at 1; see Declaration of Robert P. Norrgard, Manager of Finance and Administration, WFA, dated July 1, 1998 (Attachment B to Reply to MMS Answer (Reply)) (Norrgard Declaration), at 1-2; Ex. 1 attached to Attachment B to Reply (WFA's "Articles of Incorporation and By-Laws") at page "1"; Enclosure 1 attached to VSD Decision at 4-5.) WFA's members (which now number 23, including Basin Electric) are rural electric power cooperatives and municipal electric utilities, who use coal to fuel the Laramie River and other power generating stations. WFA was established as a separate entity to afford WFA members the economic leverage they would not have individually, when purchasing coal for their stations.

Dry Fork is a limited partnership created by Western Fuels-Wyoming, Inc., a subsidiary of WFA, acting as the general partner, and North Gillette Coal Company (NGCC), the limited partner, a subsidiary of the Phillips Coal Company. NGCC held the private, State, and Federal coal rights. Pursuant to the partnership agreement, Western Fuels had the "sole and exclusive responsibility for the day-to-day conduct, operation and management of the business of the Limited Partnership." (Ex. 3 attached to MMS Answer at 21.) The partnership was formed for the specific purpose of developing and operating a mine in Campbell County, Wyoming, and to supply coal to Basin Electric (acting on behalf of itself, Tri-State, and the other four utility companies which own the Laramie River Power Station near Wheatland, Wyoming): "[WFA] and NGCC established Dry Fork, at the behest of [Basin Electric and the other] Laramie River [Power] Station owners, to ensure a long-term coal supply for that plant." (Statement of Reasons (SOR) for Appeal to Board, dated Sept. 22, 1997, at 7; see Ex. 3 attached to MMS Answer at 1-2.) That mine is the "Dry Fork Mine," situated near Gillette, Wyoming, which began production in August 1990.

During the principal time period at issue here (from August 1990 to the date of the March 1995 VSD decision), Dry Fork Coal produced coal at its Dry Fork Mine, which encompasses Federal lands (in addition to private and State lands) leased pursuant to three Federal coal leases, WYW-271199, WYW-271200, and WYW-271201. The coal was sold to WFA, freight-on-board (FOB) at the minemouth, under a February 28, 1989, "Coal Purchase

Agreement." (Ex. 1 attached to MMS Answer.) That agreement admittedly is a nonarm's-length contract, as WFA is affiliated with Dry Fork. See 30 C.F.R. § 206.251 (1995); SOR to Board at 2; Enclosure 1 attached to VSD Decision at 2 ("Dry Fork reported coal sales for August 1990 and all subsequent months as nonarm's-length transactions"). The sales price essentially reimbursed Dry Fork for the operating costs it incurred to produce the coal sold to WFA. See Ex. 1 attached to MMS Answer at 2-3, 12-13; SOR to Board at 2.

During the relevant time period, Dry Fork's coal was transported by rail, at WFA's expense, and resold to Basin Electric at the Laramie River Power Station, under a February 17, 1977, "Coal Purchase Contract." (Ex. 2 attached to MMS Answer.) Section 10 of the agreement between WFA and Basin Electric (acting on behalf of itself, Tri-State, and the other four utility companies) provided that the sales price

shall be fixed at an amount which will produce revenues which will be sufficient, but only sufficient, together with all other revenues Seller received, to meet all costs incurred by Seller in producing or acquiring and delivering coal from resources, in Western Fuels Coal Pool Number One, [1/] including reclamation, an appropriate share of overhead for research, development and general expenditures related to resources being sold from Western Fuels Coal Pool Number One, to pay taxes, pay lease rentals and depletion, depreciation, and interest on all indebtedness of Seller for such resources, to provide for the establishment of reasonable operating reserves to provide, among other things, sufficient cash flow to meet principal repayments, all as related to Western Fuels Coal Pool Number One, and to recover an equitable share of Seller's costs associated with abandoned fuel supply projects, related to Western Fuels Coal Pool Number One, if any. [Emphasis added.]

(Ex. 2 attached to MMS Answer at 10-11.) The contract sales price essentially reimbursed WFA for its payment of Dry Fork's operating costs, the costs incurred by WFA in transporting the coal to the power station, and amortization of the money loaned by Basin Electric for the capital expenses incurred by WFA, on behalf of Dry Fork, to develop the Dry Fork Mine. 2/

1/ The "Western Fuels Coal Pool Number One" was the designated source of coal purchased by Basin Electric, for use in the Laramie River Power Station. (Ex. 2 attached to MMS Answer at 5-6.) It included coal obtained by Basin Electric pursuant to specific agreements and "any other agreements entered into by the Seller and approved as a source by Buyer," including the Feb. 28, 1989, Coal Purchase Agreement between WFA and Dry Fork. Id. at 6.

2/ Dry Fork states that the capital expenses incurred by WFA, on its behalf, included depreciation of capital assets, amortization of mine start-up costs, and depletion of reserves. (SOR to Board at 5-6; see Enclosure 1 attached to VSD Decision at 3.)

(SOR to Board at 5–6; Reply at 21; Attachment A to Reply at 1–2; Enclosure 1 attached to VSD Decision at 3–4, 7.) Basin Electric made no payment directly to Dry Fork for any of the coal from the Dry Fork mine.

WFA charges its members a management fee of \$0.125 per ton of coal sold, without regard to whether the coal comes from an affiliated or unaffiliated producer (under arm's-length or nonarm's-length contracts). (Reply at 17–18.) The fee is provided for by section 4 of WFA's By-Laws, which states, in relevant part, that each member

shall obligate itself to advance funds, from time to time, to [WFA]. Such funds shall be expended by [WFA] for capital and administrative purposes to acquire resources to supply the members' anticipated fuel requirements * * *. The amounts and times of the advances shall be determined by [WFA's] Board of Directors. [Emphasis added.]

(Ex. 1 attached to Attachment B to Reply at pages "5" to "6".) This fee was levied upon the coal sold and delivered to the Laramie River Power Station. (Reply at 17–18.) According to Dry Fork, that fee "is collected [by WFA from Basin Electric] * * * in part as compensation for the procurement and delivery of the coal, but in reality as a membership fee in the [WFA] organization as a whole." (SOR to Director, MMS, dated June 19, 1995, at 3.) It notes that the fee is the "only form of membership dues which are paid by WFA's members for their general participation in WFA." (Reply at 32.)

In valuing the coal for royalty purposes, Dry Fork included the proceeds it received from WFA in payment of its operating costs, and by WFA from Basin Electric, in payment of the capital costs incurred by WFA on its behalf. ^{3/} The resulting value was deemed similar to the gross proceeds received for comparable arm's-length contracts for like-quality coal in Wyoming's Powder River Basin. (Reply at 3.) Dry Fork did not include the WFA management fee in its royalty value of the coal, and thus did not pay royalty on the WFA management fee.

According to Dry Fork, its sale of coal from the Dry Fork Mine to WFA, for use in Basin Electric's Laramie River Power Station, diminished in October 1996, and ceased in September 1997. (Reply at 17; Attachment B to Reply at 6.)

In its March 1995 decision, VSD stated that the value of the Federal coal produced from the Dry Fork Mine was, in accordance with 30 C.F.R. § 206.257(c)(iv) and (g) (1995), "the gross proceeds accruing from the sale of coal delivered to the Laramie River Power Station * * * or market value,

^{3/} See Western Fuels-Utah, 130 IBLA 18, 26 (1994), which specifically recognized that recovery of advanced capital costs for production of coal are part of gross proceeds.

whichever is higher." (VSD Decision at 1; see Enclosure 1 attached to VSD Decision at 6–7, 13.) It thus required Dry Fork to compare "gross proceeds" to a "representative market value," both specified in the decision, to ensure that the royalty value of the coal was "not less than gross proceeds and * * * within the range of prices paid under arm's-length contracts for Powder River Basin coal." (VSD Decision at 1–2; see Enclosure 1 attached to VSD Decision at 13.)

VSD required this comparison for two time periods: (1) "August 1990 through CY [calendar year] 1994;" and (2) "CY 1995 and prospectively." (VSD Decision at 2.) Dry Fork was to retroactively adjust the royalty value of the coal during the first period, based on the difference between the value used as the basis for its original royalty payment and the higher of the gross proceeds and the representative market value, report the adjustment, and then pay whatever additional royalty was due, as required by 30 C.F.R. § 206.257(e) (1995). (VSD Decision at 2; Enclosure 1 attached to VSD Decision at 14, 16–17.) For the second period, VSD required Dry Fork to pay royalty each sales month on the basis of the "higher of [its] estimated gross proceeds for the year or the monthly representative market value" pursuant to 30 C.F.R. § 206.257(f) (1995), and then, within 3 months after the end of each calendar year, when the actual gross proceeds are known, make any necessary retroactive adjustments and pay any additional royalty then found to be due. (VSD Decision at 2; Enclosure 1 attached to VSD Decision at 14–17.)

The "representative market value" was to be based on the lower of the two FOB prices paid by WFA, under its arm's-length coal purchase contracts with Exxon Minerals, U.S.A.'s (Exxon's) Rawhide Mine and Triton Coal Company's (Triton's) Buckskin Mine, for delivery to the Laramie River Power Station. (VSD Decision at 2.) VSD also required Dry Fork to recalculate "gross proceeds" which accrued on the production and sale of coal from its leases by including the operating and capital costs paid by WFA to Dry Fork and Basin Electric to WFA and the \$0.125 per ton management fee paid by Basin Electric to WFA. Id. at 1.

Dry Fork appealed VSD's March 1995 decision to the Director, MMS, pursuant to 30 C.F.R. § 290.3, to the extent that the decision required inclusion of the \$0.125 per ton WFA management fee in "gross proceeds," for royalty valuation purposes.

In his July 1997 decision, the Acting Associate Director denied Dry Fork's appeal, concluding that VSD properly required Dry Fork to include the management fee paid by Basin Electric to WFA in the gross proceeds accruing to Dry Fork on the production and sale of coal from the Federal leases for royalty valuation purposes.

The Acting Associate Director held that the per ton WFA management fee accrued to the lessee (Dry Fork) for the production and sale of coal from the leases, and was thus part of "gross proceeds," as defined at 30 C.F.R. § 206.251 (1995). (Decision at 8–9.)

However, the Acting Associate Director noted that payments made to, or on behalf of, a lessee would not be considered part of gross proceeds if the lessee demonstrated that the payments "were not part of the total consideration paid for the purchase of coal production," in accordance with 30 C.F.R. § 206.257(b)(5) (1995). (Decision at 9 (citing 30 C.F.R. § 206.257(c)(3) (1995)).) He noted first that there was a "strong presumption" that payments made to a lessee (or its affiliate) by its purchaser constituted part of the total consideration paid for the purchase. (Decision at 9.) The Acting Associate Director then found that Dry Fork had failed to overcome that presumption, concluding that the WFA management fee was specifically paid for the purchase of the coal and did not constitute the membership dues generally paid to WFA by Basin Electric: "The [a]ppellant has provided no adequate basis in the record to distinguish this price component from the total proceeds flowing among the affiliated parties dealing in the coal." Id. at 11; see id. at 10–11.

Dry Fork appealed to the Board from the Acting Associate Director's July 1997 decision, pursuant to 30 C.F.R. § 290.7.
4/

In its SOR and in its reply to MMS' answer, Dry Fork contends that it properly computed and paid royalty on the basis of all the operating and capital costs incurred by it or by WFA, on its behalf, to produce and sell the coal from the Federally-leased lands. Appellant contends that the WFA management fee, by contrast, is totally unrelated to the production and sale of coal, noting that it is "more in the nature of association dues, calculated based on the size of the particular member's operations." (SOR at 6.) It states that the fee "goes to support public policy efforts at [WFA's] main offices in Washington, D.C.," and also covers other costs unrelated to production at any particular mine: "[WFA], for example, typically spends hundreds of thousands of dollars each year working on railroad matters, and challenging the carriers' rates." 5/ Id. at 6-7 (citing Affidavit of Norrgard, dated Sept. 19, 1997 (attached to SOR) (Norrgard Affidavit), at 2).

4/ Appellant estimates that the consequence of rendering the management fee royalty-bearing will be an annual increase in Federal royalties on the order of approximately \$60,000, which will vary depending on the amount of production actually delivered to Basin Electric. (SOR to Board at 5.)

5/ Along with its reply to MMS' answer, appellant has provided evidence that the management fee, which initially was \$0.06 per ton in 1979 and later increased to \$0.125 per ton in 1988 (where it has remained), was specifically intended to cover WFA's "general operating expenses * * * associated with current coal deliveries," including "WFA's salaries and wages, employee benefits, office rents and expenses, travel expenses, legal and accounting fees, and communication expenses." (Norrgard Declaration at 4; see id. at 4–5; Ex. 2 attached to Attachment B to Reply; Ex. 3 attached to Attachment B to Reply at 2.)

Appellant also notes that MMS does not require Exxon and Triton to include the management fee paid to WFA by Basin Electric for coal produced from Exxon's Rawhide Mine and Triton's Buckskin Mine as a part of "gross proceeds" in the royalty value of that coal, and that to impose this requirement on Dry Fork Coal is contradictory, and puts appellant at a competitive disadvantage. ^{6/} In its reply to MMS' answer, appellant provides additional evidence that WFA has received the customary per ton management fee for delivery of coal, obtained from Dry Fork and non-Dry Fork Federal sources (before and after the resales of Dry Fork coal at issue here), to Basin Electric and WFA's other member buyers, noting that it "knows of no instance," other than that at issue here, where MMS has considered the WFA management fee to be royalty-bearing, as part of the gross proceeds accruing to the lessee from the production and sale of the coal. (Reply at 31; see Attachment B to Reply at 7.)

Appellant therefore argues that the WFA management fee should not be included in the royalty value of the coal produced by it from the Dry Fork Mine. It asks the Board to vacate the Acting Associate Director's June 1997 decision.

[1] Section 7(a) of the Mineral Leasing Act, as amended, 30 U.S.C. § 207(a) (1994), requires lessees to pay royalty on the "value" of coal produced from Federally-leased land. The criteria for determining value of Federal coal for royalty purposes is set out at 30 C.F.R. § 206.257 (1995). ^{7/} The coal here "is not sold pursuant to an arm's-length contract." That having been said, section 206.257(c)(1) provides that the five specific criteria articulated for nonarm's-length contracts set forth in section 206.257(c)(2) only apply "[i]f the value of the coal cannot be determined pursuant to" 30 C.F.R. § 206.257(b). We find that the value can be determined pursuant to that section, and the criteria set forth in section 206.257(c)(2) are accordingly not reached, contrary to the determination by MMS.

^{6/} We note that appellant has also argued that the royalty value it used was proper because it was comparable to the price paid by WFA, under arm's-length contracts, for like-quality coal produced and sold from Exxon's and Triton's unaffiliated mines, and later resold to Basin Electric. MMS did not consider the fee to be royalty-bearing in these other instances. (Reply at 33.) MMS seeks to distinguish these cases on the basis that the point of sale for royalty valuation purposes, in these instances, was when the coal was sold to WFA, since it was not affiliated with the sellers (Exxon and Triton). (Enclosure 1 attached to VSD Decision at 9-10.) Here, MMS states that, since WFA is clearly affiliated with the seller (appellant), it is proper to consider the later sale to Basin Electric: "MMS must examine the proceeds a lessee's affiliate receives from a subsequent sale of [lease] production." Id. at 10. In each of these instances, however, we find that WFA was acting as agent for Basin Electric, and not for the producer.

^{7/} The royalty valuation regulations at 30 C.F.R. § 206.257 (1995) were amended effective Mar. 1, 1996, but without relevant change. 61 Fed. Reg. 5448, 5480 (Feb. 12, 1996).

The methodology set forth in 30 C.F.R. § 206.257(b) for determining value for royalty purposes clearly states that MMS is not bound by the value the lessee reports, but rather may determine value for royalty purposes after "monitoring, review and audit." 30 C.F.R. § 206.257(b)(1). In that regard, MMS must examine the coal sales contract in issue to determine whether it reflects the total consideration actually transferred from the buyer to the seller. 30 C.F.R. § 206.257(b)(2). Value may not be based on less than the gross proceeds accruing to the lessee for the coal production, including the additional consideration. Id. Equally significant, however, the lessee may demonstrate that any payments it (or its affiliate) received were not part of the consideration paid for the purchase of coal production. 30 C.F.R. § 206.257.

Under the regulations described above, the "gross proceeds" upon which royalties are assessed means the total monies and other consideration accruing to a coal lessee for the production and disposition of coal. 30 C.F.R. 206.257. This standard is based in part upon the Fifth Circuit Court of Appeal's decision in Diamond Shamrock Exploration Company v. Hodel (Diamond Shamrock), 853 F.2d 1159 (5th Cir. 1988), in that amounts received by a lessee which are subject to royalties must be related to payments for the ultimate production and disposition of the mineral, and not for some other purpose. See 853 F.2d at 1164.

Appellant Dry Fork does not dispute the meaning of the "gross proceeds" standard, but it argues that there is no factual support for the proposition that the \$0.125/ton management fee paid to WFA (its affiliate) for procurement efforts on behalf of Basin Electric, the ultimate purchaser, were payments to itself or its affiliate WFA for the production or disposition of coal by Dry Fork.

To understand Dry Fork's arguments, it is helpful to review the Fifth Circuit's 1988 decision in Diamond Shamrock, supra. In Diamond Shamrock, the court was called upon to determine whether Secretary Hodel correctly found that "take or pay" payments (not later recouped) were part of the value upon which royalties could properly be assessed in the oil and gas context. See 853 F.2d at 1164. "Take or pay" payments are those payments made to the producer when the buyer fails to purchase a minimum quantity of gas or oil. In reversing the Secretary, the court determined that the assessments in question were not payments to Diamond Shamrock for the value of the mineral produced, but were for another purpose: compensation for failing to purchase gas (Id. at 1258-59), even though the amount of compensation to the lessee/producer, as in all "take or pay" contracts, was based on the volume of gas or oil not taken below the minimum amount required.

In 1996, the District of Columbia Circuit Court of Appeals decided Independent Petroleum Association of America v. Babbitt (Independent Petroleum), 92 F.3d 1248, 1258 (D.C. Cir. 1996), in which the court analyzed

whether settlement payments were royalty bearing. There, settlement payments were made by a buyer of gas effectively to terminate a long-term gas supply contract. In Independent Petroleum, as in Diamond Shamrock, the court reversed the Secretary and found that the settlement payments were not royalty bearing. Id. at 1260.

These two decisions address the basis of royalty valuation. As another Federal court stated in 1999 when addressing these decisions in the coal context:

Simply because they involve gas and oil as opposed to coal is not a compelling reason to ignore them. The decisions' discussion of the assessment of royalties is functionally indistinguishable from the standard drafted in the regulations. Indeed, MMS recognized this when it drafted the gross proceeds standard to reflect the Diamond Shamrock decision.

Black Butte Coal Co. v. United States (Black Butte), 38 F. Supp.2d 963, 971 (D.Wyo. 1999).

In Black Butte, *supra*, a case in which the Wyoming District Court reversed the Interior Board of Land Appeals' affirmation of an MMS determination, the court determined that deferment payments to the lessee, measured by the tonnage volume of coal contracted-for but deferred, were not royalty bearing. 38 F. Supp.2d at 974. The court in Black Butte related its decision to Diamond Shamrock and Independent Petroleum when it stated:

These decisions are helpful because they show when the agency has or has not found sufficient facts to show a connection between minerals extracted from the ground and payments made. Indeed, these cases simply reiterate what the agency has stated all along: Payments are not royalty bearing unless they are related to the severance of minerals, and factual support for finding the connection must be found in the form of recoupment against the future purchase of minerals. Accordingly, it bears repeating that the meaning of the gross proceeds standard is not at issue in this case, at issue is only whether substantial evidence supports finding the deferral payments as part of the gross proceeds. [Emphasis added.]

Id. at 971.

From our careful review of the record in this case, we find that the MMS decision cannot stand. The Acting Associate Director reasoned that in Dry Fork's instance, there was a connection between the coal produced and the management fees paid by Basin Electric to Dry Fork's affiliate WFA, and that "[a]ppellant has provided no adequate basis in the record to distinguish this price component from the total proceeds flowing among the affiliated parties dealing in the coal." (Decision at 11.) He noted first

that there was a "strong presumption" that payments made to a lessee (or its affiliate) by its purchaser constituted part of the total consideration paid for the purchase. (Decision at 9.) The Acting Associate Director then found that Dry Fork had failed to overcome that presumption. (Decision at 10-11.)

The mistake made by MMS here is that it ignored the facts before it. The facts are undisputed that the \$0.125 per ton management fee was paid to WFA for purposes totally separate and distinct from any individual producer's production of coal; rather those funds were to be expended by WFA for capital and administrative purposes to acquire resources to supply the members' anticipated fuel requirements. Conversely, the Acting Associate Director never stated upon what basis he concluded that the fees represented payments for the costs of producing coal by Dry Fork or its affiliate.

Moreover, the payments were never recouped or credited against the future price of coal, a critical factor cited by the Black Butte court as necessary to show that the fees were actually for producing coal, and thus royalty bearing. See Black Butte, *supra* at 971; see also EEX Corp. v. U.S. Dept. of Interior, 111 F. Supp.2d 24, 33 (D.D.C. 2000). WFA paid Dry Fork the full contracted price for the coal, a price which the record shows was more than competitive with arm's-length sales entered into by WFA and Basin Electric with independent producers Triton and Exxon, and against which Dry Fork's sales were measured. This concern that the full contracted price was paid was another critical factor relied upon by the Black Butte court in determining that the decision could not stand in that case. See *id.* Moreover, MMS does not and cannot dispute that all members of the WFA (including Basin Electric) were charged the management fee, regardless of whether their coal was obtained from affiliated or unaffiliated producers (under arm's-length or nonarm's-length contracts).

No coal producer, other than Dry Fork, was directed to include the fee when calculating gross proceeds for royalty purposes. When MMS was specifically asked by the Board to comment on its failure to require others to include the fee as part of their gross proceeds, MMS chose not to answer the Board's November 22, 2000, Order. MMS does not dispute that the management fee assessed to all members of the WFA was levied to provide for capital and administrative purposes related to acquiring resources to meet the members' fuel requirements, as distinguished from capital for production of coal. See Western Fuels-Utah, 130 IBLA 18, 26 (1994). In fact, numerous affidavits submitted by appellant more than establish this. See affidavits of Darold Koch (Dry Fork), Robert P. Norrgard (WFA), Robert L. McPhail (Basin Electric), Joel W. Buck (Tri-State), and L. Christian Hauck (Sunflower Electric).

After careful review, these management fee payments and the payments in issue in Diamond Shamrock, Independent Petroleum and Black Butte, *supra*, cannot be distinguished functionally. Like the payments at issue

in those cases, the management fees paid to WFA by Basin Electric were never recouped or credited against the future purchase of coal. In each case, the full purchase price was paid. And like those cases, not one single fact supports the MMS position that a royalty connection exists between the WFA payment for coal produced by Dry Fork and the payment of the management fee to WFA by Basin.

The instant case must be contrasted with Stauffer Chemical Co. of Wyoming, 54 IBLA 85 (1981), cited in the VSD Decision. In that case, a producer sold to a buyer affiliated with the producer (by virtue of the fact that it held a controlling interest), who resold the mine product to a third party purchaser, paying the producer the net proceeds of the resale, less a commission which reimbursed the buyer for the costs incurred in marketing the sodium. Stauffer Chemical Co. of Wyoming, 54 IBLA at 87. We particularly noted that the affiliated buyer did not purchase the lease product for the purpose of resale on its own behalf, in the manner of a distributor, but rather for the purpose of resale on behalf of the producer, in the manner of a producer's marketing agent. Id. at 90 ("It cannot be said that [the affiliated buyer] is purchasing for resale on its own account," emphasis added). We held that, in these circumstances, the royalty value of the lease product should be the entire net proceeds paid to the affiliated buyer on the resale, since the commission was simply not deductible. Id. at 89-90; see FMC Corp., 54 IBLA 77, 81-82 (1981).

Unlike Stauffer Chemical Co., supra, the initial buyer (WFA in this case) is also affiliated with the ultimate purchaser, Basin Electric. And unlike Stauffer Chemical Co., supra, where the initial buyer was acting solely for the producer, WFA was acting for Basin Electric and the fee received was for procurement services, not marketing services for the producer.

And unlike Stauffer Chemical Co., supra, the management fee paid to WFA is not a sales commission received as part of the proceeds of the resale of the coal produced by Dry Fork, but payment by Basin Electric to its agent for arranging the purchase and timely delivery of coal to its electrical generation plant. The management fee is clearly a Basin Electric expense subject to the discretion of WFA, and thus of Basin (by virtue of Basin Electric's controlling interest in WFA): "The amounts and times of the advances shall be determined by [WFA's] Board of Directors." (Ex. 1 attached to Attachment B to Reply at page "6"; see Ex. 3 attached to Attachment B to Reply.) Also, it is plainly intended to reimburse WFA for the costs incurred in procuring the coal, and has no relationship to any service performed for Dry Fork, which has no say in the determination of the amount or manner of payment. Unlike Stauffer Chemical, the fee may not be added to the sales price to determine royalty value of the coal.

We thus find that the management fee paid by Basin Electric to WFA cannot be considered a marketing fee or sales commission for finding buyers and marketing Dry Fork's coal. WFA is reimbursed by Basin

Electric for the costs it incurs on arranging deliveries on behalf of the buyer, not sales on behalf of Dry Fork, the seller. WFA did not market coal for Dry Fork. That market existed when it entered into the purchase contract with Dry Fork on behalf of Basin. WFA, as Basin Electric's procuring agent, secured the coal required by Basin when and where required, in return for which it received the fee. WFA was, quite simply, Basin's agent for procuring and delivering coal to Basin Electric during the entire time period at issue here. It performed a procurement service. This relationship stands in contrast to cases decided by the Board where the agent served the producer, not the buyer, such as represented in AnSon Co., 145 IBLA 221, 222–23, 225–26 (1998) (agent purchases and then resells gas to third party), Branch Oil & Gas Co., 143 IBLA at 205, 207 (agent purchases gas and then gathers, compresses, and resells it to power company), Taylor Energy Co., 143 IBLA 80, 81–82 (1998) (agent purchases and then resells gas); Arco Oil & Gas Co., 112 IBLA 8, 8–9, 11 (1989) (agent obtains buyers and arranges for transportation downstream of delivery point), and Walter Oil and Gas Corp., 111 IBLA 260, 260–61, 264–65 (1989) (agent obtains buyers, negotiates sales contracts, and monitors sales).

WFA's principal purpose is to supply Basin Electric and its other members with coal for their power generating operations. (Ex. 2 attached to MMS Answer at 1; Norrgard Affidavit at 2 ("[WFA] * * * is responsible both for the procurement of coal and for arranging for the coal's transportation and delivery to the members' powerplants".)) It does so on behalf of Basin Electric, not on behalf of Dry Fork. (Ex. 1 attached to MMS Answer at 1 (appellant and WFA "desire to enter" into the Feb. 28, 1989, Coal Purchase Agreement "to permit [WFA] to secure a further supply of coal for sale to Basin [Electric] under the [Feb. 17, 1977,] Basin [Electric/WFA Coal Purchase] Contract".)) (Emphasis added.) It is accurate, as appellant would urge, to view WFA as acting on behalf of Basin Electric. See, e.g., Reply at 30 ("WFA purchases, ships and delivers [coal] on behalf of [its] member buyers").

Further, the fact that the fee paid by Basin Electric represents compensation for procurement activity by WFA, on behalf of Basin Electric, is evident in the fact that there is no other money which flows to WFA, other than what basically covers the operating and capital costs incurred by WFA to secure the coal required by Basin Electric. For royalty purposes, it is thus critical that the fee received by WFA is not for marketing Dry Fork's coal (subject to royalties), but for procurement of coal for Basin Electric (not subject to royalties). This is manifested by the fact that the market value of the coal was fully realized at the point of sale to WFA, at the Dry Fork Mine, where it was accepted by an agent for the purchaser under a typical area sales contract. See Trapper Mining Inc., 144 IBLA at 213–14; FMC Corp., 54 IBLA 77, 79–81 (1981) (citing United States v. Southwest Potash Corp., 352 F.2d 113, 116–18 (10th Cir. 1965), cert. denied, 383 U.S. 911 (1966)).

As further evidence that the management fee was improperly included by MMS, Dry Fork asserts that the "value" it used for royalty purposes, which included the operating and capital costs paid by WFA and Basin

Electric (but not the management fee paid by Basin Electric), was "comparable to [the value of] 'like-quality coal produced' in Wyoming's Powder River Basin." (SOR to Director at 2.) More specifically, it says that its "valuation methodology, excluding the management override, results in a valuation comparable to the market prices [WFA] pays for the Rawhide and Buckskin coal." (SOR to Board at 8; see Reply at 12–13, 16–17.) Nowhere does MMS contradict this statement or indicate in its pleading that the value on which Dry Fork paid royalties was not at least equivalent to the "gross proceeds derived from, or paid under, comparable arm's-length contracts * * * for sales * * * of like-quality coal produced in the area," in accordance with 30 C.F.R. § 206.257(c)(2)(i) (1995).

In fact, MMS has compared appellant's nonarm's-length gross proceeds with the lower of Exxon's and Triton's contract prices paid by WFA on sales from the Rawhide and Buckskin mines (not including the management fee), which is deemed by MMS to constitute a "representative market value," and then has used the higher value as the appropriate royalty valuation. (VSD Decision at 2.) It appears that, in the absence of evidence to the contrary, appellant's nonarm's-length gross proceeds will, in fact, be higher than the so-called representative market value. While we do not specifically fault MMS in this comparison, it should have raised questions that could only be answered by comparing the fact that the difference in the royalty paid by Exxon and Triton could only be explained by the fact that the management fees were incorrectly added to gross proceeds received by Dry Fork but not added to the gross proceeds received at either the Buckskin or Rawhide mine.

Finally, we must examine the disparate way in which MMS has interpreted the term "gross proceeds" when including the per-ton management fee in Dry Fork's gross proceeds, and not insisting that it be a part of the gross proceeds from the coal sold by producers such as Triton and Exxon, which held similar supply contracts with WFA to support the needs of Basin Electric's facility, and for whom the same per-ton management fees were not included in gross proceeds. The court in Black Butte addressed a similar concern regarding disparate treatment of a producer:

This court heeds the Court of Claims' guidance [in Black Butte Coal Co. v. United States, 27 Fed. Cl. 699, 703, vacated on other grounds, 14 F.3d 612 (Fed. Cir. 1993)] and bears the monetary interest and inconsistent interpretations of DOI in mind when determining the issues in this case. Undeniably, it is in the best interest of DOI to find that the deferral payments were subject to royalties. Further, MMS found that payments were not part of the gross proceeds under nearly identical circumstances in the Wolverine decision. These things, combined with the fact that the government chose to disregard every piece of evidence pointing toward finding no connection between the payments and the production of coal makes the Court's decision less complicated. Simply put, while

the Court agrees with the government's stated definition of gross proceeds (as does Black Butte) the Court must find that substantial evidence does not support finding that the payments in question were part of the gross proceeds. [Emphasis added.]

Black Butte, *supra* at 973). We have the same problem with the Acting Associate Director's decision. Dry Fork has put forth uncontroverted evidence that the \$0.125 per ton payments were made by Basin Electric to WFA for capital and administrative purposes to acquire resources to supply WFA's members (of which Dry Fork was not one) anticipated fuel requirements. This collective, explicit purpose and the disparate treatment of the fees collected from WFA members for coal sold to WFA by others is diametrically at odds with finding that the payments have a nexus to coal production.

We specifically requested that MMS address the disparity in its treatment of different producers in our November 22, 2000, Order and asked MMS why it has never considered the fee part of the royalty value of any coal purchased and then resold by WFA to Basin Electric and its other rural electric power cooperative members for other than that produced by Dry Fork. (Reply at 17, 31; SOR to Director at 3-4, 8; Enclosure 1 attached to VSD Decision at 9; Norrgard Affidavit at 2.) As noted earlier, MMS chose not to respond.

While we are not bound by what the parties to the arm's-length transactions and MMS have, in the past, deemed to be encompassed, for royalty valuation purposes, by "gross proceeds derived from[] * * * comparable arm's-length contracts," under 30 C.F.R. § 206.257(c)(2)(I) (1995), we carefully observe deviations from longstanding past practice on the part of MMS, or other regulatory agency. While MMS could properly change its approach concerning management fees paid for legitimate procurement activities of a buyer, if justified by law or regulation, we will not permit this change when justified by neither, and when the consequence is to incorrectly value Federal coal for royalty purposes. MMS, like other Federal agencies, is required to consistently apply its own regulations in the determination of the correct payment of royalty to the United States in the case of appellant's nonarm's length or other comparable arm's-length transactions. See Atlantic Richfield Co. v. Hickel, 432 F.2d 587, 591-92 (10th Cir. 1970); Marathon Oil Co., 16 IBLA 298, 313-19, 81 I.D. 447, 454-57 (1974), set aside on other grounds, Marathon Oil Co. v. Kleppe, 407 F. Supp. 1301 (D. Wyo. 1975), aff'd, 556 F.2d 982 (10th Cir. 1977); see also Phillips Petroleum Co., 117 IBLA 255, 263-64 (1991); Sun Exploration and Production Co., 112 IBLA 373, 386-92, 97 I.D. 1, 8-11 (1990).

We thus conclude that, in his July 1997 decision, the Acting Associate Director improperly denied Dry Fork's appeal from VSD's March 1995 decision, requiring it to include the "management fee" paid to its affiliate (WFA) by its affiliate Basin Electric in the gross proceeds accruing

to appellant from the production and sale of the coal from the Federally– leased lands for royalty valuation purposes. The burden of demonstrating that MMS erred in its royalty valuation was on appellant, Walter Oil and Gas Corp., 111 IBLA at 265, and it successfully carried that burden.

Accordingly, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 C.F.R. § 4.1, the decision appealed from is reversed and the underlying VSD determination is vacated.

James P. Terry
Administrative Judge

I concur:

R. W. Mullen
Administrative Judge

